Snapshot

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SNAPSHOT 2023-05

New leasing guidance for entities under common control

The FASB issued ASU 2023-01, *Leases (Topic 842): Common Control Arrangements,* to address two issues related to accounting for arrangements between entities under common control: (1) the terms and conditions to be considered, and (2) leasehold improvements.

While "common control" is not defined in U.S. GAAP, the concept is used in other Codification topics, such as ASC 805, *Business Combinations.* To assess whether entities are under common control, practitioners should consider, among other things, the SEC's staff's observations documented in EITF Issue 02-5, "Definition of 'Common Control' in Relation to FASB Statement No. 141." Those observations indicate, for example, that two entities are considered to be under common control when an individual, enterprise, immediate family member, or a shareholder group subject to a voting agreement controls more than 50 percent of the voting interest in both entities.

Issue 1: Terms and conditions

Scope

The first issue applies only to entities that are *not* any one of the following:

- Public business entities
- Not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or over-the-counter market
- Employee benefit plans that file or furnish financial statements with the SEC

Practical expedient

Prior to the issuance of ASU 2023-01, ASC 842 required all leases between related parties, including entities under common control, to be accounted for based on their legally enforceable terms and conditions. The new guidance provides a practical expedient for arrangements between entities under common control that allows an in-scope entity to use the written terms and conditions of the arrangement to determine whether it contains a lease, rather than using the legally enforceable terms and conditions. Under this practical expedient, an entity should consider whether the written terms and conditions convey the practical, rather than enforceable, right to control the use of an identified asset. If the arrangement is or contains a lease, the entity must classify and account for that lease based on the written terms and conditions under the practical expedient. The practical expedient applies to both lessors and lessees, and can be elected on an arrangement-by-arrangement basis.

If the entities in the arrangement cease to be under common control, the accounting would depend on whether (1) the arrangement *was a lease* when the entities were under common control, and (2) the arrangement *is a lease* now that the entities are no longer under common control, as shown in the following table.

The arrangement:	Is still a lease	Is not still a lease
Was previously a lease	Classify and account for the arrangement based on legally enforceable terms and conditions; may involve modification accounting	Apply relevant lease termination guidance
Was not a lease previously	Treat as a new lease	Follow other GAAP

Issue 2: Leasehold improvements

Scope

The second issue applies to all entities, both public and private entities, that are the lessee in a lease with a lessor under common control and have recognized leasehold improvements related to that lease.

Accounting for leasehold improvements

Prior to the issuance of ASU 2023-01, ASC 842 required all lessees to amortize leasehold improvements over the shorter of their useful life or the remaining term of the lease. The new guidance requires amortizing leasehold improvements for leases between entities under common control over the useful life of those assets to the common control group, regardless of the lease term. There is an exception to this rule when the asset underlying the common control lease is itself leased by the lessor from a party outside the common control group (and is then subleased to the lessee), and that lease does not contain a bargain purchase option or transfer of ownership. In that case, the useful life of the leasehold improvements cannot exceed the term of the lessor's lease. Impairment testing for those leasehold improvements also utilizes the useful life to the common control group.

Under the new guidance, when the lessee no longer controls the use of the asset underlying the common control lease, the leasehold improvements are accounted for as a transfer between entities under common control. That is, the lessee records a distribution to the common control lessor through an adjustment to equity.

If during the lease term the parties to a lease either cease or start to be under common control, any change to the amortization period of the associated leasehold improvements that result from applying the new guidance for Issue 2 is accounted for prospectively as a change in accounting estimate.

Disclosure

When the useful life of leasehold improvements accounted for under the common control guidance is greater than the term of the related lease, a lessee is required to disclose the following:

- The unamortized balance of leasehold improvements
- The remaining useful life of the improvements to the common control group
- The remaining lease term

Effective date and transition

The new guidance will be effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2023. If an entity adopts the new guidance in an interim period, it must apply the guidance as of the beginning of the fiscal year that includes the interim period. An entity may early adopt the guidance in any financial statements that have not yet been issued or been made available for issuance. Therefore, entities that have not yet issued, or made available for issuance, financial statements for the period of adoption of ASC 842 may elect to adopt this new guidance at the same time they adopt ASC 842.

Transition: Issue 1

Entities that have already adopted ASC 842 may adopt the guidance related to Issue 1 in either of the following manners:

- Prospectively, by applying the guidance only to arrangements that commence or are modified after the ASU's effective date
- Retrospectively to the beginning of the period in which the entity adopted ASC 842

Regardless of the transition method, the new guidance permits an entity to document in writing any *existing* unwritten terms and conditions of an arrangement between entities under common control before it makes the financial statements in which it has adopted the new guidance available for issuance. Certain transition disclosures are required.

Transition: Issue 2

Entities that have already adopted ASC 842 may adopt the guidance related to Issue 2 in either of the following manners:

- Prospectively, by applying it either to all new leasehold improvements or to all new *and* existing leasehold improvements
- Retrospectively to the date when the entity applied ASC 842. Any reversal of amortization or impairment as a result of retrospective adoption should be recognized through a cumulative effect adjustment to retained earnings.

Certain transition disclosures are required.

For more information about accounting for leases under ASC 842, see our accounting guide "Leases: Navigating the guidance in ASC 842" on grantthornton.com.

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